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SIPDIS

SENSITIVE

TREASURY FOR INTERNATIONAL AFFAIRS - MMILLS AND MSCHWARZMAN
STATE FOR E, EUR/SE, AND EB/IFD
NSC FOR MBRYZA AND TMCKIBBEN

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SUBJECT: US TREASURY OFFICIAL'S VISIT: LOCAL ECONOMISTS
WAITING FOR NEW IMF STANDBY

REF: ANKARA 4455

1. (Sbu) Summary: In a round of meetings with visiting US Treasury official Marshall Mills at the end of July, GOT economic officials, IFI representatives, and private sector analysts painted a picture of Turkey being at an important juncture in defining its policy direction over the next 1-3 years, particularly its fiscal stance and relationship with the IMF. Prolonged uncertainty over its eventual direction has made markets uneasy and fragile. However, both technocrats inside the government and the private sector believed that the GOT will eventually decide on the direction necessary for market confidence and financial stability -- specifically, targeting a primary surplus at or near 6.5% of GNP and concluding a new, disbursing Stand-by Arrangement with the IMF. Though the cost of delaying this decision has been and continues to be substantial, in the past few days the GOT has announced it will pursue a disbursing SBA. Judging by post contacts, comments, the structural reform side continues to be the weakest area in the Turkish authorities, program. End Summary.

Near-term uncertainties

2. (Sbu) The fiscal framework - In meetings with Turkish Treasury U/S Ibrahim Canakci, State Planning Organization (SPO) U/S Ahmet Tiktik and others, Mills and economic officers discussed future fiscal policy measures such as the GOT's new three-year program (reftel) and the 2005 primary surplus target. On the three-year program, Turkish officials generally offered consistent explanations although some, such as Canakci, described it being a broad effort encompassing all areas of economic reform while others, like Tiktik, focused more on the debt sustainability elements. None were able to offer a date for an announcement of the details of the program. On the primary surplus the economic bureaucrats were unanimous in wanting a "high" or "very high" number but were unwilling to give specifics, stating only that it was a decision that would be made and announced later. Regarding the composition of expenditure, U/S Tiktik asked for US support to exempt some investment expenditure from the primary surplus calculation citing the need for increased spending in this area due to high unemployment.

3. (Sbu) Policy "anchors" - Mills met with private analysts from the banking and manufacturing sectors. The large majority of analysts were clear about what was needed to maintain and/or improve market sentiment: a new disbursing IMF program and a positive EU decision in December. Most also explained that the IMF was more important for near-term economic stability, stating that the EU will provide a more positive outlook only for the medium term. (Note: the IMF Turkey mission chief, Reza Moghadam, made an unexpected visit to Ankara last week, to consult on the GOT 3-year program. Post will report septel on the Moghadam visit). Several of the market contacts said there would be a significant loss of confidence if the GOT did not seek a disbursing SBA and/or suffered an unfavorable EU decision on accession negotiations. GOT technocrats, Canakci, Tiktik and others, are supportive of a new disbursing SBA, while also being optimistic about the EU. However, until the past few days, the political leadership delayed any decisions or announcements, perturbing the markets. Yapi Kredi Bank Vice President Huseyin Imece likened the GOT's behavior to an airline pilot who does not provide information to passengers during normal turbulence and thus makes

them more worried than they may need to be.

Market fragility

14. (Sbu) Why the delay? - Many of the private analysts wondered out loud why the government was delaying, particularly when the uncertainty costs them in terms of credibility and higher interest rates. They offered different explanations: the GOT is waiting to see what the EU decision will be, as indicated by the Commission's October 6th report, in the hopes that the EU anchor may substitute for the IMF; the AK party is not monolithic and the GOT is still selling a new program to certain factions within it; communication with the market-oriented technocrats is ineffective.

15. (Sbu) Financing a growing current account deficit exacerbates market worries - Next to talk of policy anchors, the wider than expected current account deficit was the most discussed issue. GOT estimates of the end-2004 deficit were \$10.5 billion or 3.5-4% of GNP. Market projections were a bit higher, gathering in a range of \$12-13.5 billion or 4-4.5% of GNP. GOT officials pointed to the measures they have taken to curb domestic demand, namely a reduction in incentives for purchasing cars, instructing the state banks to curtail their consumer lending and not spending the revenue over performance from the first part of the year. They insisted they are ready to do more in coming months, if needed, but were not overly concerned about the growing deficit at the moment. Markets explained their nervousness regarding the current account given the sensitivity of Turkey's capital flows to interest rate developments in the United States and the ease with which there could be a halt or even reversal of these flows.

16. (Sbu) Markets, guarded optimism - Nearly all market participants correctly predicted that the GOT would eventually accept that it has no other alternative to a disbursing SBA. They also predicted that the EU decision will be favorable. In a meeting with Bender Securities, Mills asked why such expectations did not seem to be reflected in asset prices, which remain high. Murat Gulkan, Bender Managing Partner, replied that risks are not negligible and the alternative scenario, while low probability, would be very costly so investors are not yet ready to put their money in. Some of the analysts wondered if the government truly understood its economic position. For them, the reluctance of the government to accept a strong macroeconomic framework and IMF program undermined already limited GOT credibility.

Medium-term structural reform prospects discouraging

17. (Sbu) Judging by post contacts, comments, prospects for structural reform that will support sustained growth are less encouraging than for the broader macroeconomic framework. Progress toward privatization of the state banks was a particular case in point. In a meeting early in the visit, the World Bank stated that a strategy for state bank privatization, developed by McKinsey consulting, would be announced in December and executed in 2005. Turkish officials, including Canakci, BRSA chairman Tevfik Bilgin and Ziraat Bank CEO, Can Akin Caglar seemed to be operating with a longer time horizon with only a very distant prospect of eliminating effective state control.. Canakci and Caglar offered a timeline with privatization beginning in 2006 or 2007 and then only by piecemeal IPOs, rather than block sales. Bilgin--until last year the CEO of Halk Bank--went as far as to say that privatization of Halk and Ziraat banks was impossible due to their asset structure. Vakif Bank was the most likely of three remaining state banks to be privatized, he said, but even this was not likely. Private sector representatives had similar views to Bilgin's, believing that privatization in the near to medium term was unrealistic.

18. (Sbu) On the issue of non-banking sector privatization and FDI, political will and legal system deficiencies were cited as the principal barriers. Both U/S Tiktik and Treasury Director General Memduh Akcay, pointed specifically to the legal system with Akcay stating, "If I was the IMF I would focus on this." The Privatization authority also highlighted the problems they have been having with the courts, specifically mentioning the cases of TUPRAS and Turk Telecom.

